CPAB Audit Quality Insights Report:

Annual Inspections Results

2018
This year we celebrated CPAB’s 15th anniversary as Canada’s public company audit regulator.

CPAB was established in 2003 by the Canadian Securities Administrators, the Office of the Superintendent of Financial Institutions and the Canadian Institute of Chartered Accountants (now CPA Canada) as part of a series of reforms to strengthen investor confidence and protect our capital markets. Since then CPAB has provided regulatory oversight of accounting firms that audit Canadian public companies to drive consistent quality. Our skilled professionals conduct inspections of public company audits and impose remedial actions to improve audit quality, engage with key stakeholders, and share insights with the audit community in Canada and abroad.

CPAB has seen improvement in overall audit quality in the past 15 years. Audit firms, audit committees and management have demonstrated a greater focus on delivering quality audits and CPAB has leveraged learnings from our inspections program to inform our discussions with key stakeholders including audit professionals, audit committees, other regulators and investors. Still, there is more to be done. Our recent inspection findings are similar for some firms and have risen at others over last year’s cycle – this tells us sustainable audit quality is still a challenge across the firms. We believe the strength of a firm’s audit quality management systems will be critical to accelerating improvements in the sustainability of high-quality public company audits.

Inspecting for quality – 2018 inspections program

All firms that audit a Canadian public company must register with CPAB and be inspected (273 firms at December 31, 2018). Each year, CPAB inspects all firms that audit 100 or more reporting issuers. There are currently 14 firms in this group which audit about 7,000 reporting issuers. These firms, and their foreign affiliates, audit approximately 99.5 per cent of all reporting issuers as measured by market capitalization. All other firms are typically inspected at least once every three years. We provide mandatory recommendations to improve audit quality which the audit firm must implement within a defined period – usually 180 days; this deadline is much shorter for more serious findings, particularly where there may be a potential restatement of the financial statements.

During 2018 CPAB inspected 32 firms (2017: 45) and 139 engagement files (2017: 154).

Overall, the trend in audit quality results has improved for most firms over the past 15 years; however, our current inspections show that sustainable, consistent audit quality remains a challenge in Canada. All participating audit firms must enhance their commitment to continuous improvement at every level of their organization and embed a culture of quality to deliver audits that are of consistently high quality. Quality management systems will be critical to this improvement. 2018 marked the first year of CPAB’s enhanced assessment of the quality management systems at the country’s four largest public accounting firms and we found that all firms require improvement.
Audit engagement file findings: significant findings higher in 2018, improvement needed now

Our inspections of the 14 public accounting firms reviewed annually showed an overall increase in significant findings over 2017. Of note, approximately half of our findings related to the execution of basic audit procedures. Results at eight of the 14 firms remained stable, but there were notable increases at the other six firms. And while there has been a consistent overall reduction in inspection findings over the past 15 years, this has not occurred across all firms, reinforcing the importance of strong quality management systems in sustaining and improving the level of audit quality.

In 2018, 28 per cent of the files we inspected had significant findings (2017:12 per cent). We inspected 122 (2017:128) audit files and identified significant findings in 34 (2017:15). Most of those findings required the firm to carry out additional audit procedures to determine the need, if any, to restate the financial statements due to material error. The remaining findings required firms to add evidence to the audit file to show they had obtained sufficient and appropriate audit evidence with respect to a major balance sheet item or transaction stream. For the 14 firms inspected annually, there are two restatements to date.

![Graph showing significant findings trend from 2011 to 2018](image-url)
While most audits we inspect comply with the required standards, recurring engagement file inspection themes indicate that weaknesses in quality management systems persist, leading to inconsistent audit execution. Firm policies and processes − at both the leadership and engagement team levels − that manage risk and get the right people working on the right things at the right time, all the time, are essential to delivering high quality audits, consistently. In response to these issues, in 2018 CPAB began to introduce a new methodology to assess existing quality management systems and to help accelerate improvements at the country's four largest public accounting firms – Deloitte LLP, Ernst & Young LLP, KPMG LLP and PwC LLP.
This new assessment approach requires firms to demonstrate the effectiveness of their quality management systems. It emphasizes the need to systemically embed audit quality processes (preventative and detective) into ongoing operations across the entire assurance portfolio so that audit deficiencies are identified and corrected in real time or, at a minimum, before the audit opinion is released. Monitoring and inspecting audit quality after the fact is not enough.

To provide some context, Canadian securities commissions require reporting issuers to document and certify their controls (and underlying processes) over financial reporting that management uses to assess operating effectiveness – known as certification. We took a similar approach to our assessment of the firms’ audit quality management systems. We expect firms to fully document their firm-wide quality management systems and control processes, including the testing of the effectiveness of each control. And, just like the early days of certification, while progress has been made, we found a lack of robust documentation and formalized self-assessment mechanisms across the firms.

Each firm has made and continues to make a significant effort to improve, better articulate and document its quality management systems and controls, and to link them to CPAB’s five assessment criteria: accountability for audit quality, risk management, talent management, resource management, and oversight. This foundational work was driven by the global network centre in some firms, and by the Canadian firm’s national office in others. CPAB acknowledges that the firms are rethinking how they manage their operations to deliver higher audit quality and more consistent execution across offices and practices.

So far, CPAB’s quality management systems review work has focused on assessing firm risks, control design and operating effectiveness, and reviewing firm documentation of each process. We considered the objective, resources, methodologies, type of risk, and severity of finding(s) related to each control and targeted the inter-relationships between firm risk management and firm talent and resource management processes.

CPAB’s Firm Quality Management Systems Model: Five Criteria for Assessing Quality

1. **Accountability for Audit Quality:** Accountability for audit quality is clearly defined and appropriately delegated across firm leadership, functional areas, engagement teams (including specialists and experts) and engagement partners.

2. **Firm Risk Management:** Systems to identify, effectively measure and monitor client risk, including audit risk, and appropriately align talent to client risk (Portfolio Management).

3. **Firm Talent Management:** Sufficient talent capacity from engagement partners to all levels of assurance staff, including industry experts and specialists (i.e. valuations, tax and IT), to execute quality audits.

4. **Firm Resource Management:** Process/ability to re-align and match talent (skills) on a proactive, timely basis, including specialists, to changing audit needs, priorities and risk profiles.

5. **Oversight:** Ability/systems to provide firm leadership visibility on progress of audit work and proactively initiate issue resolution, as required, compared to client requirements and deadlines.
Initial findings

- Descriptions of processes and controls, in many instances, were too high level to enable an assessment of whether the control was appropriately designed and effective.
- Sometimes controls identified by the firms are policies or after-the-fact detective controls that would not identify an audit deficiency before the audit report is released – firm quality monitoring processes performed after release of an audit opinion, for example.
- Certain controls did not achieve their intended control objective or were not operating effectively. For instance, in tight time frames, progress reports and monitoring were neither sufficiently frequent nor granular enough to enable proactive intervention by leadership.
- In many instances, corrective actions taken to impact audit quality as a result of a control trigger were not described or evidenced. As an example, for an unplanned transition in lead engagement partner, specific actions taken by the firm to support the new partner were not evident.
- We encountered circumstances where firms described centralized processes and controls but could not demonstrate the consistency and effectiveness of those or similar processes at a regional or office level.
- We noted situations where processes and controls varied from location to location resulting in an increased risk in the overall control framework.
- In many instances, firm testing was focused on whether the control had been performed rather than an assessment of the effectiveness of the control.

Specific weaknesses and control gaps were identified at all firms and require remediation. Of note, in many cases our file-related significant findings were indicative of deficiencies in the firms’ quality management systems. CPAB’s evaluation framework for firm quality management systems comprises the following five categories: acceptable, acceptable with opportunities for enhancement, needs improvement, requires significant improvement, and no control in place. Overall, three firms need improvement and one firm requires significant improvement. The latter firm recognized gaps in its systems and determined the need to restructure its overall quality management systems; as a result, CPAB was unable to complete its assessment.

To attain an acceptable quality management system assessment, all firms must advance their self-assessment work, remediate deficient processes and implement new controls. CPAB will continue to review these and require improvements as necessary.

Quality management systems – questions for audit committees

1. CPAB has identified that all firms need improvements – what are the key steps the audit firm is taking to improve the firm’s audit quality management systems?
2. What tools and sources of information does firm leadership use to determine if issues requiring intervention are communicated and escalated in a timely manner (in addition to communication by an engagement partner)?
3. How does national leadership identify engagements where industry knowledge and resourcing need to be augmented to deliver a quality audit (other than through a firm’s regional leadership review)?
4. How is the responsibility and accountability for audit quality delegated and monitored within the firm among national and regional leadership, specialists, firm experts and the engagement team?
5. How do firm quality management systems address the challenges of significant technological innovations and cyber threats?

Firm-specific results

Deloitte LLP, Ernst & Young LLP, KPMG LLP, PwC LLP

CPAB inspected 80 (2017:86) audit engagement files across Deloitte LLP, Ernst & Young LLP, KPMG LLP, and PwC LLP and identified significant inspection findings in 16 (2017:6) of those files.

Two of the firms’ inspections results were comparable to 2017.
In 2018, CPAB inspected 23 (2017:23) audit engagement files across the four other national/network firms. The number of significant findings was relatively stable at three firms but the prevalence of other inspection findings (while not significant, these findings indicate areas for improvement) indicate more work is needed to deliver consistent audit quality.

One firm continued to experience challenges; its action plan response to CPAB’s 2017 inspection did not have the intended impact. We have required that firm to develop a revised action plan to remediate this decline in quality.

These four firms, which audit about one per cent of Canadian reporting issuers by market capitalization (approximately 670 public companies), accounted for 10 files with significant inspection findings (2017:6). There is one restatement to date.

BDO LLP, Grant Thornton LLP, MNP LLP, Raymond Chabot Grant Thornton LLP

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Davidson & Company LLP, DMCL LLP, Manning Elliott LLP, RSM Canada LLP, Smythe LLP, UHY McGovern Hurley LLP

Three of the six large regional firms experienced an increase in significant inspection findings in 2018. CPAB inspected 19 (2017:19) engagement files and found significant inspection findings in eight files (2017:3).

It appears that quality initiatives implemented in response to previous inspections are having a positive impact at the three firms with stable or improved results. The other three firms need to do more to analyze the root causes of poorer quality and develop processes that ensure audit risks are appropriately identified and consistently managed across their public company audit practice.

These six firms account for about one per cent of Canadian reporting issuers by market capitalization (approximately 950 public companies). There are no restatements to date.

Non-annual firms

As part of the 2018 inspection cycle CPAB inspected 18 non-annually inspected firms (2017:31 firms) and identified eight (2017:13) files with significant findings. There were three restatements.

CPAB has executed a tailored inspection methodology to better assess quality management systems at those non-annual firms with fewer than 25 reporting issuers.

Common inspection findings and potential root causes of factors leading to poorer audit quality are incorporated into our risk analysis of these firms and the companies they audit. This facilitates proactive outreach to understand how the firms manage these risks and to discuss appropriate audit responses targeted at improving quality, along with strategic intervention through select file inspections.
CPAB’s risk-based methodology for choosing files (and the specific areas of those files) for inspection is not intended to select a representative sample of a firm’s audit work. Instead, it is biased towards higher-risk audit areas of more complex public companies or areas where the audit firm may have less expertise, so there is a greater likelihood of encountering audit quality issues. Our inspections do not look at every aspect of every file and are not designed to identify areas where auditors met or exceeded standards. Results should not be extrapolated across the entire audit population, but instead viewed as an indication of how firms address their most challenging situations.

At December 31, 2018, 273 audit firms were registered as a Participating Audit Firm (PAF) with CPAB. Eighteen new firms registered (10 Canadian and eight foreign firms) and 31 voluntarily terminated their registration over the calendar year. Audit firms who voluntarily participate in the Protocol for Audit Firm Communications of CPAB Inspection Findings with Audit Committees (Protocol) share significant file-specific inspection findings with their clients’ audit committees. A significant inspection finding is a significant deficiency in the application of generally accepted auditing standards related to a material financial balance or transaction stream where the audit firm must perform additional audit work to support the audit opinion and/or is required to make significant changes to its audit approach. Twelve of the 14 annually inspected firms participate in the Protocol – a complete list is available at www.cpab-ccrc.ca.

The majority of CPAB’s inspection findings in 2018 required the audit firm to carry out additional audit procedures to verify there was no need to restate the financial statements due to material error. The remaining findings required the audit firms to add considerable evidence to the audit file to show they had obtained sufficient and appropriate audit evidence with respect to a major balance sheet item or transaction stream. The results of carrying out additional audit procedures resulted in five restatements to date or four per cent of files inspected (2017: three restatements or two per cent of files inspected).

CPAB actively engages with firms throughout the inspections cycle to resolve issues as they arise during our reviews. Our Rules provide a robust framework of remediation and disciplinary mechanisms to address audit quality deficiencies at the firm and file levels. This allows us to respond quickly when we believe more work is required to support the audit opinion. For example, CPAB operates under the principle that, within 10 days of determining a file deficiency, we notify the firm; we then require their remediation plan within another 10 days. CPAB expects that firms will remediate file deficiencies before their reporting issuer’s next quarterly report or next audit committee meeting.
If a firm fails to improve, CPAB has the authority to impose discipline at three levels: Requirement, Restriction and Sanction. This can include publicly naming a firm and restricting it from auditing public companies and helps to ensure that firms act quickly and appropriately to resolve deficiencies. Finally, where CPAB imposes a disciplinary action related to a defect in the firm’s system of quality control, and the firm fails to address it to CPAB’s satisfaction within a specified time period, the firm must notify the audit committees of all its reporting issuers. As a general rule, CPAB begins with imposing a Requirement for the first instance of disciplinary action:

- Requirements typically involve CPAB mandating the firm to take an action to make a change to its audit practices to improve audit quality. This will generally stay between CPAB and the firm, unless notification to the securities commissions is required otherwise by virtue of NI 52-108. If audit quality has not improved during a follow-up inspection with an audit firm with a Requirement on it, or if CPAB feels the performance of the firm and the severity of the lack of audit quality in the first instance requires so, CPAB would impose a Restriction.

- Restrictions characteristically involve CPAB limiting the audit firm’s practice in some way, and CPAB will specifically notify the securities commissions of the Restriction, in addition to the notification that may be required otherwise under NI 52-108. If there is demonstrated continued lack of improvement of audit quality with an audit firm with discipline already in place, or if in the first instance there is demonstrated egregious behavior, CPAB would impose a Sanction.

- With the imposition of a Sanction, CPAB would severely limit the audit firm’s practice and obligate the firm to notify the audit committees of its reporting issuer clients. CPAB would also notify the securities commissions.

CPAB actively managed disciplinary actions in 2018 to address audit quality matters. As at December 31, 2018 there were Requirements on three firms (2017:6) and Restrictions on two firms (2017:4). In 2018 one firm was subject to Sanction and subsequently withdrew as a PAF.

Of the five firms operating with Requirements or Restrictions, CPAB has:

- Required certain firms to perform enhanced engagement quality control reviews or in-flight reviews.
- Required certain firms to undertake additional training for specific accounting or audit topics.
- Required certain firms to implement action plans to improve audit quality and consider hiring additional resources.
- Limited the acceptance of new reporting issuers for five firms.
- Applied a monetary assessment to certain other firms for the recovery of CPAB’s cost of monitoring approved requirements.

A firm may petition for a review proceeding in the following three scenarios: 1) when the board intends to make public the weaknesses, deficiencies and recommendations in the system of quality control, or deficiencies in specific engagements, not addressed or remedied to the satisfaction of the board; 2) when the board proposes to impose Requirements, Restrictions and Sanctions in the case of a Violation Event; 3) in connection with an application for membership not accepted by the board. Investigations may take place when the board considers that a Violation Event may have occurred, and it wishes to seek information and the cooperation of the firm with respect to such matters. A Violation Event is defined in CPAB’s Rules as: (i) an act or omission in violation of CPAB’s Rules or chartered professional accountant standards; (ii) a failure to supervise a person to prevent such violations, and the person has committed the act or omission; (iii) a failure to cooperate with the terms of an inspection or investigation; or (iv) a failure to comply with the terms of any Requirement, Restriction or Sanction imposed by CPAB.

No review proceedings or investigations were conducted in 2018.
Auditing fair values in business combinations

Acquired assets and liabilities must be recorded at their estimated fair values. In 2017 and 2018 a common inspection finding was insufficient work performed to assess the reasonableness of management's financial inputs and assumptions incorporated into the fair value estimate of assets acquired or liabilities assumed. Other examples of significant findings this year related to provisional estimates and arrangements outside the business combination.

Fair value estimates can be provisional at year end if management is still seeking information regarding the business combination. These amounts may be adjusted before the end of the measurement period in the following year if additional information improves the precision of the estimate. However, the auditor still must perform sufficient procedures to assure the provisional estimates are not materially misstated based on information available at year end. CPAB identified instances where minimal or no audit procedures were performed to understand how management made the estimate and what additional information might be required, or to assess the reasonableness of the underlying assumptions. As a result, the auditor would not have identified a material misstatement in the assets or liabilities acquired.

When negotiating an acquisition, the parties may also agree to settle previously existing arrangements or enter into new but separate arrangements. Careful consideration of the facts and circumstances is necessary to determine what agreements should be considered part of the business combination and what should be treated separately – failing to do so could result in a material misstatement in the assets and liabilities recognized. CPAB identified instances where the auditors did not have a sufficient understanding of the relationships between the parties to the transaction and the nature of the business arrangements to objectively assess whether the accounting was appropriate.

Impairment of assets

Assets are frequently tested for impairment to determine if they need to be written down to their recoverable amount. There are various acceptable methods for estimating this amount – the most common incorporates a projected discounted cash flow model. However, determining appropriate inputs to this model can be difficult. For example, the conditions that triggered the impairment test are often related to uncertainty about future value and cash flows.

In a number of cases, engagement teams accepted the inputs to management's cash flow model without sufficiently testing if those inputs were reasonable and supportable. It is a concern if auditors do not test the reasonability of the inputs and consider contradictory evidence of possible variations in the amount or timing of the cash flows or other factors (such as illiquidity) that a potential buyer would reflect in valuing the future cash flows. If inputs are not reasonable and an impairment loss should have been recognized the financial statements are misstated. Investor confidence could be compromised if the impairment is not recognized in the appropriate period.

Revenue recognition

A company that earns revenue from the construction of assets in accordance with a contract may recognize that revenue as the work progresses provided key elements can be reliably measured (e.g. total contract revenue, costs incurred, cost to complete and stage of completion). While understanding management's process for estimating these amounts is a critical first step, inquiry of management alone is not sufficient without corroborating evidence.

Engagement teams are often challenged to obtain sufficient audit evidence to support both the measurement and reliability of the key elements. This challenge increases when there are complicating factors like modifications to the contract without formal approval or outstanding claims against the customer for costs related to delays or specifications changes. Errors result in incorrectly recorded revenue, gross margins and earnings, and can significantly impact investors’ evaluation of company performance.
CPAB continues to work with stakeholders on several critical audit quality matters that should also be top of mind for directors of public companies, including regulatory access to audits done in foreign jurisdictions, the growing number of reporting issuers with crypto-assets in the Canadian market, and the automation of the audit.

**Foreign jurisdiction audits – access improving but some barriers persist**

Investors should be concerned when foreign laws and regulations impede or reduce the auditor oversight they have come to expect in Canada; CPAB must have direct access to work performed by component auditors. We continue to actively engage with the Canadian securities regulators to get appropriate access to audit work completed in foreign jurisdictions where this access is currently restricted so that we can continue to safeguard audit quality and protect the interests of the investing public in Canada.

Certain countries, including China, continue to prevent CPAB from inspecting the audit work of Canadian public companies conducted in their jurisdictions. (For a detailed list of jurisdictions where CPAB is unable to access working papers, please visit www.cpab-ccrc.ca).

Where a Canadian reporting issuer has operations outside the country, directors should make sure the group auditor has assessed and independently reviewed, if necessary, the work of foreign affiliates before relying on it in the audit of the consolidated entity.

**Crypto-assets – auditing in a new frontier**

CPAB is aware of approximately 50 Canadian reporting issuers that either hold crypto-assets or are engaged in crypto transactions. To date we have inspected the audits of three reporting issuers that were active crypto-miners and/or holders of crypto-assets and found significant findings in all three files reviewed. The audit firms are in the process of remediating the deficiencies.

In December 2018, CPAB published Auditing in the Crypto-asset Sector outlining our expectations of auditors across several higher risk areas. CPAB continues to actively monitor developments in this emerging ecosystem.

*Directors of crypto businesses or reporting issuers holding crypto-assets should consider the experience the engagement team has with those assets and the underlying distributed ledger systems, whether the auditor used a crypto expert to assist in the audit, and what, if any, audit procedures were performed to address risks unique to this industry.*

**Data analytics and other emerging technologies – disruptive enablers**

To date CPAB has seen a modest level of this activity in our inspections, mostly in the areas of matching of accounts, data visualization and automation of traditionally manual procedures. We continue to watch the development and implementation of new tools and procedures and provide our perspective on how they can enable enhanced audit quality. For example, we are assessing procedures performed to ensure the completeness and integrity of client data used in data analytics audit routines.

Directors should consider asking their auditor if changes will be made to the audit approach to incorporate emerging technology tools (data analytics, artificial intelligence, machine learning, etc.), and if so, what support will be needed, and what are the benefits and challenges. Other points for query could include the purpose of the data analytic, and how company data is stored, secured and validated for accuracy.
LEARN MORE

CPAB’s 2018 annual report and public inspections reports, detailed information on the Protocol, and thought leadership publications are available at www.cpab-ccrc.ca.

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